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US consumers in debt hole – Fed keeps ‘em digging

WE SUGGEST: Prolonged weakness not discounted by stocks, bonds

SUMMARY: US consumers are suffering low nominal income growth, as the crisis saps bonuses and stock option profits. Only a lurch into dis-saving, via borrowing, has prevented falling real consumer spending. But the Fed’s low-rate incentives to borrow are also trashing the dollar, worsening already serious inflation, and hitting real incomes. A weaker dollar and falling real Treasury yields could continue.

The Fed’s policy for dealing with American households’ grossly excessive debt – “let them borrow more” – was still working in January. Real consumer spending has stopped dead in its tracks over the past 3-4 months, but not because of consumers’ reluctance to borrow.

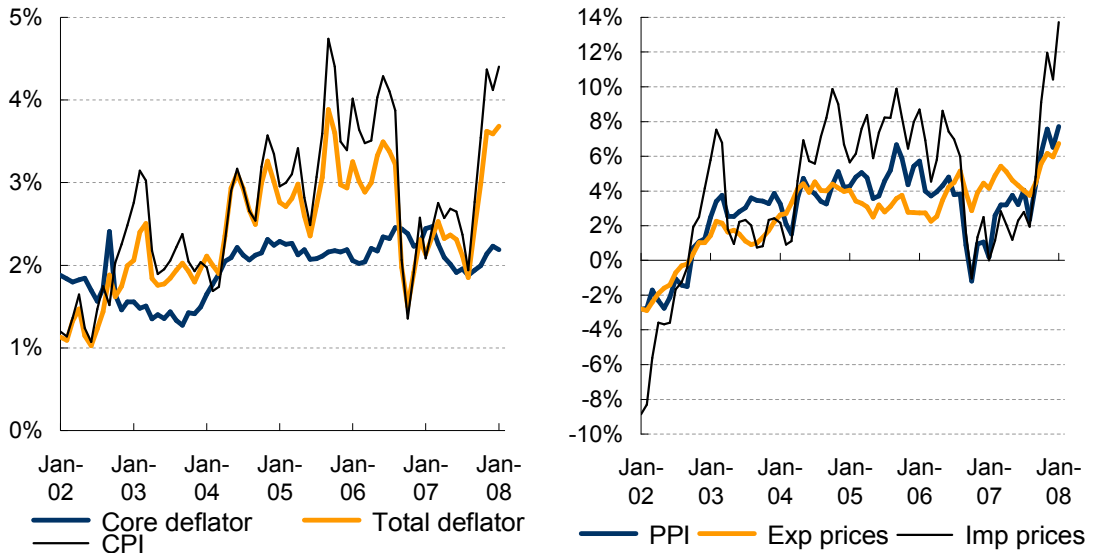
Personal savings rate, % of disposable income



The savings rate in the past three months has been at its lowest ever level, excluding Katrina distortions. It is lesser real income growth that is causing weak real spending. One cause of this is a distinct slowing of nominal income growth. Personal income growth is now at only a 4% annual rate, more than two percentage points slower than a year ago. It may well be that these data will be revised down, since the vital bonuses and stock-option profits are largely estimated, and the statisticians may not yet be aware of the loss of income arising from the credit crunch. (After all, many banks do not seem to be!) In that case, the savings rate would have to be even more negative, implying greater recent consumer borrowing, than the chart above suggests. With the (hourly) Employment Cost Index rising at little over 3%, the contribution of real estate commissions, bonuses and

stock option profits likely to be negative during 2008, and probably only a negligible growth in jobs, the growth rate of nominal incomes could easily fall further, to 3%.

Various US inflation measures, 12-month % change



Layered onto the weakness of nominal income is the buoyancy of inflation. Here, the Fed is actively weakening the economy by trashing the dollar and encouraging every speculator and his dog to buy food, metal and energy commodities. Not only was the CPI up 4.4% in the 12 months to January, and the consumer deflator 3.7%, but the shorter-term (6-month and 3-month) rates of change are faster. Import prices were up nearly 14% in January, and commodity prices have risen further since then, as the Fed's drastic intentions have become clearer. The Fed may be making borrowing cheaper – for the time being – but it is also forcing the consumer to do more of it to offset the rise in basic living costs. It is tempting to ascribe deep schemes to the Fed – deliberate inflationary default against the US's major foreign creditors – but blunders induced by panic may be the more plausible explanation. After all, the US still needs to raise lots of money to fund the deficit.

\$ since around US 2004 elections



Much hinges on Chinese patience, or stubborn-ness. As long as China keeps its capital export controls, it will be building up FX reserves faster than its current account surplus, which is running at about a \$350 billion annual rate. And as long as China wishes to keep control of the appreciation of the yuan against the dollar it will mostly have to pile up the greenback in PBoC's FX reserves. As long as this goes on, the upward pressure on the euro will remain strong. And, consumer borrowing notwithstanding, the ultimate destination of much of its reserve pile-up will be US Treasuries. Given the trend of inflation, it is small wonder the inflation-linked Treasuries have been booming.

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